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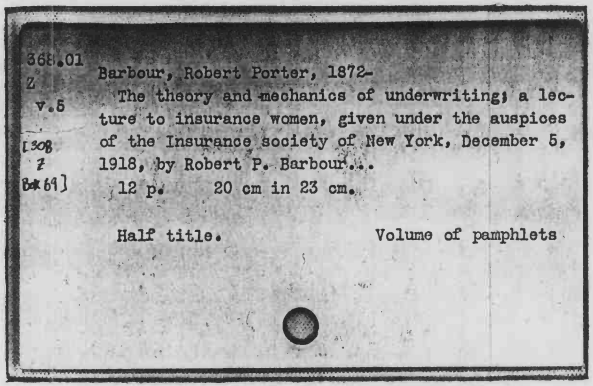

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The Theory and Mechanics *of* Underwriting

A LECTURE
To Insurance Women
Given Under the Auspices *of*
The Insurance Society *of* New York

December 5, 1918

By
ROBERT P. BARBOUR
Secretary
North British & Mercantile Insurance Co.
Mercantile Insurance Co. of America
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10 March, 1920 - C.R.W.

THE THEORY AND MECHANICS OF UNDERWRITING

IN the limited time at our disposal we can only scratch the surface of this subject, but I hope to be able to give you an understandable outline of the main principles of underwriting and something of the processes involved.

Fire insurance underwriting is based on the law of average, both in the selection of risks and the fixing of lines. To secure satisfactory results from the application of this law some system definite in its general character must be established and followed, and such a system, when applied both to classes and to retentions, becomes what is commonly referred to as the "general underwriting policy of the company."

A system of this nature can be more definite regarding the amounts to be retained on the various classes of risks than it can be as to the other factors involved, because in fixing lines we deal with specific, known

quantities, whereas in considering physical and moral hazards we are dealing with what is more or less unknown. These hazards are not susceptible of absolute measurement, because a considerable element of uncertainty must always exist as to how serious any hazard may be. For this reason it is impossible to demonstrate whether any given rate is neither more nor less than the proper and adequate one for any specific risk. All these factors must be dealt with on the basis of average.

An underwriter will frequently decline a risk on physical grounds and may give many and detailed reasons for so doing, but in the last analysis what he has in his mind, consciously or otherwise, is the thought that the risk is not acceptable at the rate offered because such rate is relatively below the average for the class. Why does a company establish a prohibited list, i. e., a list of classes to be declined for its account? Is it because there is something inherently hazardous in those classes to make them unprofitable? As a rule the answer will be found in one of the two following reasons:

First—That there are not a sufficient number of risks in the class so that lines thereon will constitute an average, or the company does not consider itself in position to obtain a sufficient number of lines to form an average.

Second — That the average of rates on the risks in such class is too low to cover losses and expenses.

One of the phenomena of the insurance business is that certain classes have always borne rates too low to be self-sustaining, with the result that a majority of the companies decline them, or, if forced for one reason or another to write thereon, retain only small lines. Yet there is no class embracing a sufficient number of individual risks that cannot be underwritten profitably at some average rate, although perhaps only at one that would be prohibitive and therefore not obtainable over the class as a whole. One of the difficulties of our business is that we have no cost marks. Our goods are sold, delivered and often well-nigh consumed before we can reckon the cost, and here is where judgment and experience are of so great value, for they are the chief guides in gauging the quality of the rate.

There are few classes that are constant in having either a good record or a bad record, for the ratio of loss is a shifting one, varying from year to year; while there are many classes that may be relied upon to produce a profit over a period of years, almost all of them are subject to bad times, so you see this again brings us back to the law of average.

The problem of the underwriter in the selection of business is to secure that which is

profitable on the average, and sufficiently so to overcome the losses on such of the business as from time to time does not prove profitable, thus leaving a satisfactory margin on his trading as a whole.

Having laid down a plan regarding what classes to write and what to avoid, the next step is to select the individual risks within each class with such skill that the record thereon shall be as good or better than the average record of the class as a whole. The majority of properties in a given class will be what are termed "fair" risks, having the usual construction, the customary occupancy hazards and the normal care, and it is a natural inference that such average risks will produce a fairly even record. The underwriter does not greatly concern himself about these, since a profit may be expected so long as the level of rates for the class is adequate. The better and poorer than average risks are the ones that need attention and call for a definite policy regarding their treatment. Hence, the underwriter is constantly on the lookout for variations from the normal and regards with suspicion a risk that has anything unusual about it, scrutinizing it with greater care than if of the every day kind.

To determine whether a risk is average in character it must be considered in relation to the class wherein it falls and from the standpoint of both physical and moral

hazard. That which is usual in one class is unusual for another and a condition found in one class if present in another would condemn it.

What has been said regarding the selection of risks is also true with regard to the fixing of lines, for these need to be based upon some system of average, since an abnormal line may bring an abnormal loss and so upset the underwriting record. It does not so much matter what the size of these lines may be so long as they are based upon some definite plan and are not inconsistent with the volume of business written. This does not mean that the same line should be retained on all kinds and classes of risks; far from it. The amount varies according to the class of risk and the character of the individual risk within such class. An abnormal line for one risk or class would be a normal one for another, but the general underlying plan of line limits is to so fix the amounts to be retained on risks in the various classes that the result of operating in accordance therewith will be to strike an average in losses. The limit of line named is usually intended to apply to the best risks in the class and to be modified in proportion to the lesser desirability of the risk.

If the underwriter is equipped with a thorough knowledge of his company's general underwriting policy as to classes and

lines he then may proceed to consider the merits of each individual risk offered and to deal with this in the light of such information as may be obtainable. On the physical side he considers the character of the construction, the nature of the occupancy, the seriousness of the internal and external exposure, the extent and reliability of the public and private protection, and finally the adequacy of the rate. To guide him in forming this judgment there are extensive and carefully prepared maps showing the type of construction, the general surroundings and the public protection available for all buildings in the more important cities and towns. This information is supplemented by inspections made by bureaus and by private inspectors and field men; also by town reports made by the National Board or by rating associations.

The underwriter must be familiar with the burning qualities of the different forms and types of construction, not merely classified as frame, brick, stone, concrete and fireproof, but as well the variations within each such general class; also the usual hazards connected with heat, light and power and with at least the simpler manufacturing processes, together with the relative value of the various kinds and degrees of protective equipment, both public and private. All these things have a bearing on the acceptance of business and the fixing of lines thereon.

Much is said of moral hazard in fire insurance and perhaps it will profit us to consider this somewhat more fully. By moral hazard is meant personal character, integrity, solvency and general habits of life, and it may be divided into two groups, one expressed by the word "honesty" and the other by the word "carelessness." Honesty is something that cannot be proven by line and measure, for none of us know how honest we are except by the degree of temptation which we have resisted. Underwriters must judge of this feature by the record of a man, by such of his characteristics as can be learned, and by the apparent temptations there may be for dishonesty. Information regarding the insured is obtained from a variety of sources. First of all, companies depend on their local agents not to insure any parties that are unknown or who bear a poor reputation in business life. Considerable dependence is placed also on ratings and reports made by commercial agencies and by a man's past record as to fires.

A commercial rating is of value as indicating whether one has sufficient means to conduct his business or to maintain his property. Men who are doing well are not subject to the same temptations as those who are in difficulties, although not all financially

successful men are good moral hazards, nor all unsuccessful ones bad moral hazards. Yet one who sees his property slipping away from him may be tempted to recoup by a dishonest fire, or one dishonest in business might use a fire to destroy the evidence of wrong-doing, and care must be used where circumstances point to such conditions. Commercial ratings must be considered in relation to the character and size of the business operated. A rating of from $3,000 to $5,000, with fair credit, is considered a normal rating for the average retail grocer, but such a rating for one operating a large wholesale grocery would be unusually low and call for some investigation. As a rule, where the rating is not normal, whether in amount of resources or degree of credit assigned, it is customary to obtain a special report, which goes into considerable detail regarding assets, liabilities, business history, reputation, etc., thus furnishing to the underwriter information upon which to form some judgment of the moral hazard.

Then there is the question of fire record. If a man has had a fire the underwriter wishes to know whether the adjustment developed any circumstances or facts that were not satisfactory from the standpoint of honesty or carelessness. If there is no criticism, the fact that he has had a fire does not militate against him. If, however, a man has

had two or more fires it is a more serious matter, and some companies make it a rule to decline insurance in such cases on the ground that the man may be dishonest or be tempted to be, and anyway he is too unfortunate to be a good insurance risk. Of course, it is a different matter where the man owns a number of scattered properties occupied by tenants, although in such cases if fires are too frequent they need careful investigation.

Perhaps in nothing more than fire insurance does the "appearance of evil" count for so much and departures from the normal are quite as likely to be from the moral hazard standpoint as the physical.

By way of illustrating the abnormal risk that is likely to induce moral hazard, let me quote the following examples of the kinds of risks that underwriters scrutinize with great care when offered:

Saloons, distilleries or breweries in a locality that has gone "no license"; stores with an undue quantity of shop-worn, old fashioned or otherwise unsalable goods; factories poorly located as to transportation facilities or not adapted to the kind of manufacturing done, or where labor is difficult to procure, or where labor troubles are frequent and bitter; industries that depend for profit on patents in litigation or expiring; old fashioned buildings that find it hard to compete with modern ones; houses in chang-

ing or deteriorating locations likely to become unsuitable; a business operated by a man in the name of his wife; industries of all kinds that are unwelcome, perhaps nuisance in the neighborhood, and in general any business that is "going to seed."

In all these cases conditions are abnormal and *because* they vary from the normal should be carefully investigated. A motive may exist for having a fire wherever it would profit the ones interested, either in disposing of something not wanted, or of something unsalable at anything like the original cost. Over-insurance, that is, insurance in excess of a fair value, is considered one of the great causes of so-called moral hazard fires, and this is likely to be in truth a burning question in the near future.

The other phase of moral hazard that is summed up under the word "carelessness" refers more especially to housekeeping conditions. Care and cleanliness are "first aids" to fire prevention, for carelessness is the cause of more fires than poor construction, or hazardous processes. The best protective equipment or device is likely to fail unless maintained in good workable condition and a poor building, kept scrupulously clean and in order, is often a better risk than a good building that has poor care. Carelessness is a state of mind, and to distinguish it from the other phase of moral hazard this is some-

times called the "temperamental" hazard. Such hazard is found not only in the individual, but also to run through whole industries, and is expressed in bad housekeeping conditions, due, perhaps, to the class of men engaged therein or to the class of labor performed. Furthermore, there are certain races of people whose factories, stores and homes are habitually dirty and ill-kept and fires follow as a natural consequence with greater frequency than where such conditions are unusual.

A bad moral hazard, as with a bad physical hazard, is a menace not only to the property immediately concerned, but also to all others exposed thereby, and that is one of the reasons why a building with many tenants is usually considered less desirable than where there are but one or two. A great financier once said that he was willing to take long chances in lending money to men of good character, and likewise in our business personal character counts very largely, for if we can be sure of the moral hazard we can take great chances on the physical side.

From all of this we may see that insurance underwriting has many sides and angles. It is not wholly a question of moral or physical hazard, of construction or occupancy, or care or location, of exposure or protection, of line or rate, but a blend of all of these things, of which the rate is the great-

est factor. Nor does the underwriter gain his information entirely from maps and surveys, commercial agencies or fire records. When one stops to think that insurance touches every human industry one may realize the many avenues from which helpful information may come, for whatever is going on in this world of ours affects some business or some home, and may likewise affect the desirability of insurance thereon, and so the mind of a good underwriter must be the repository of facts about very nearly everything under the sun, for there is little that may not prove useful to him in his work.

The power of observation and assimilation, the habit of thought and study, an analytical and practical mind, a retentive memory, thoroughness and plenty of common sense; these are the traits of a good underwriter to which experience puts the finishing touches.

Perhaps the treatment of this subject has been more general than you would have wished, and there are many features that have not been mentioned, such as reinsurance, distribution of liability, block and district limits, and others, but I have tried to tell you of the things that lie at the foundations of the underwriting structure, believing that the more we know of the fundamentals the broader will be our grasp on the specific tasks of our every day work.

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